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The Need To Improve Auditing in the Savings and Loan Industry

Statement of
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Before the
Committee on Banking, Finance and Urban Affairs
House of Representatives

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Mr. Chairman and Members of the Committee:

We appreciate the opportunity to be here today to discuss auditing in the savings and loan (S&L) industry and our recent report to you entitled, CPA Audit Quality: Failures of CPA Audits to Identify and Report Significant Savings and Loan Problems (GAO/AFMD-89-45, February 2, 1989). Today, we would like to address

--the auditing problems we found during the course of our review,

--the recommendations we are making to the public accounting profession to address those problems and bring about improvements in the overall quality of S&L auditing, and

--suggestions we have to this committee to help strengthen the role of auditing as an effective regulatory and oversight tool.

AUDITING PROBLEMS

At the request of your committee, we reviewed the quality of audits of S&Ls in the Dallas Federal Home Loan Bank District. Our review focused on the most recent audits performed by

independent certified public accountants (CPAs) of 11 S&Ls out of a total of 29 S&Ls which failed in the Dallas district during the period January 1, 1985, to September 30, 1987.

The latest audit reports for the 11 S&Ls before they failed showed combined positive net worth totaling approximately $44 million. At the time of the S&Ls' failures, which ranged from 5 to 17 months after the date of the last audit reports, the 11 S&Ls had combined negative net worth totaling approximately $1.5 billion.

We concluded that for 6 of the 11 S&Ls, CPAs did not always audit and/or report the S&Ls' financial or internal control problems in accordance with professional standards. The problems essentially fell into two areas: (1) CPAs did not adequately evaluate whether S&Ls could collect on their outstanding loans and (2) CPAs did not adequately report on S&Ls' financial, regulatory, and internal control problems. The problems the S&Ls in our review were experiencing were similar to the problems we have found in other failed S&Ls.

While audit problems do not cause S&L failures, audits do play an important role in the regulatory and oversight process. They are an integral part of the system of controls designed to identify and report problems in S&Ls when those problems first arise, so that timely corrective action can be taken to resolve

them.

It is imperative that we have an accurate, reliable gauge on the extent of the financial problems in the S&L industry. If this committee, federal regulators, and others are to resolve the industry's current crisis, audit reports must be able to fully describe the significant financial problems. Otherwise, existing problems may continue to go undetected.

Although all of the problems we found were not necessarily of the same magnitude, we believe they were all significant enough to bring to the attention of this committee, the public accounting profession, and regulatory and oversight bodies such as the Federal Home Loan Bank Board. Resolving the problems we identified should provide the opportunity to help ensure that future CPA audits of S&Ls will be performed in a quality manner.

Fieldwork Problems

I will briefly summarize the problem areas we identified.

1. Evaluation of high-risk loans. Many S&Ls over the past decade have moved away from traditional home mortgages and into concentrations in riskier land and acquisition, development, and construction (ADC) projects. CPAs in our review did not always have

evidence that they adequately recognized and evaluated the financial risks that such projects posed to S&Ls.

2. Identification of loan problems. In the mid-1980s, many S&Ls began experiencing problems in collecting on their ADC loans, many of which were "balloon" type loans in which the entire principal and interest became due at once, usually 2 to 4 years after the loan was first granted. To avoid default, in many cases problem loans were renewed or restructured. The CPA firms in our review did not always identify or adequately evaluate the financial effect or risk of these restructured loans.

3. Verification of management assertions. In many cases, management of troubled S&Ls contended that problem loans were collectible or, in the cases of default, that collateral underlying the loans was sufficient to cover the outstanding loan balance. Standards require auditors to obtain independent corroboration that key management assertions are true--often a time-consuming but necessary audit function. However, the CPAs in our review did not always perform this function and, instead, often relied on management's unsubstantiated oral assertions that problem loans were collectible.

4. Follow up on examiners' findings. Federally insured S&Ls are subject to examination by the Federal Home Loan Banks' auditors. These examinations are made primarily to help federal regulators know whether S&Ls are managed properly and whether they comply with federal regulations. They also provide useful information to a CPA who is issuing an opinion on the fairness of the financial statements. We identified cases where the auditor did not follow up on those problems which were identified by examiners and which we believe cast doubt on the S&L's financial statements.

Reporting Problems

In the area of reporting, CPAs did not always disclose certain problems, which we believe might have affected the usefulness of financial statements to others. These include the following:

1. Improper accounting practices. In two cases in our review, CPAs did not point out in their audit reports that their S&L clients had materially misstated their income. In one of those cases, the S&L client had lost four times as much money as it had reported in its

financial statements for that year.

2. Regulatory violations. In some cases, CPAs did not report serious regulatory violations, such as excessive loans to single borrowers and formal cease and desist or similar orders by regulators. Thus, report users were unaware of those operating risks and the corresponding potential regulatory actions, all of which may have impacted the S&Ls' operations.

3. Insider loans. Extensive amounts in loans to shareholders or other "insiders" went undisclosed in some of the cases in our review, leaving report users unaware of the potential financial effects of related-party influences.

4. Risk and limited geographic concentrations. The risks inherent in high concentrations of loan activity in limited geographic areas or loan types which had experienced economic difficulties were not always fully disclosed to readers of the audit reports in our review.

5. Internal control problems. Management and internal control problems have been cited by GAO and others as a leading cause of S&L failures. Although the auditors

in our review were aware of material internal control problems at the S&Ls in our review, they often did not report on those problems or characterize them as being material.

THE PUBLIC ACCOUNTING PROFESSION CAN IMPROVE S&L AUDITING

The American Institute of CPAs (AICPA), the most important professional group in the area of public auditing, can take the lead in addressing and resolving the kinds of auditing problems noted in our review. While the auditing problems we found are significant, we believe that they can be corrected. Accordingly, we made two overall recommendations to the AICPA to help improve the quality of S&L auditing.

First, we recommended that the AICPA revise its guidance for auditing S&Ls. The current S&L audit guide is outdated and does not adequately address a number of areas for ensuring that S&L audits are properly performed. We believe that the AICPA should move quickly to revise the S&L guide to include detailed discussion and specific requirements for, among other things,

--identifying the nature and inherent risks of land and ADC loans,

--evaluating the potential effects of increases in

restructured and past-due loans,

--following up on the work of federal examiners,

--ensuring that regulatory violations and formal regulatory actions are disclosed, and

--properly reporting all material weaknesses in internal controls.

Second, we recommended that the AICPA communicate the results of our review and bring to the attention of its members any other recently noted S&L problems. Such communication should include discussion of the types of problems that may occur in auditing S&Ls and should require that

--staff performing S&L audits have sufficient knowledge of S&L operations,

--audit methodologies be specifically tailored to take into account changes in the operations of their individual S&L clients and the S&L industry environment,

--evidence of all audit work be properly documented in the working papers, and

--financial risks, regulatory violations and formal regulatory actions, and internal control weaknesses be fully disclosed in audit reports.

We think that an effective way for the AICPA to develop and successfully implement our recommendations would be to establish

formally a project team or task force which would be charged with developing a comprehensive action plan to see that real improvements are brought about in the quality of S&L auditing. The AICPA might consider a task force similar to the one it established in 1985 to address problems GAO noted in the quality of CPA audits of governmental entities.

Response by the AICPA

In the past, the public accounting profession has demonstrated its ability to bring about needed changes and improvements in accounting and auditing. The profession has responded to suggestions and recommendations GAO has made to help strengthen guidance and controls for improving the quality and effectiveness of auditing.

In the case of S&L audits, we believe that the profession can and will move expeditiously to ensure that S&L audits are performed in a quality manner. Discussions that we have had with representatives of the profession confirm that steps are being taken to ensure that our recommendations are implemented and that audit quality is improved.

The AICPA, as well as this committee, needs to send a message to auditors that improper, ineffective, and inaccurate S&L audits cannot be tolerated. Auditors must clearly describe

the problems and risks facing S&Ls. Instead of bowing to any pressure from S&L clients or others to consider or present best-case scenarios, auditors should be instructed to exercise more professional skepticism when auditing and reporting on S&Ls' financial statements. For example, when evaluating reserves for estimated loan losses, auditors should be as conservative as possible. If auditors are going to err, then it is better to err on the side of caution. Otherwise, we are likely to see some of the same problems we are discussing here today.

STRENGTHENING THE ROLE OF AUDITING AS A REGULATORY AND OVERSIGHT TOOL

Improving audit quality alone, however, will not provide all the answers to the question of how to make auditing an effective regulatory and oversight tool in the S&L industry. To maximize the benefits that can be achieved from auditing, it is necessary to ask auditors to do more than just opine on the financial statements.

In this regard, we believe that CPA firms should be specifically required to report on S&Ls' internal controls and compliance with specific laws and regulations. Such a requirement would enhance the role of auditing as a regulatory and oversight tool by providing an early warning to federal regulators and others of management and systems problems that, if

not properly addressed, could contribute to financial failures.

In January of this year, we testified before this committee that financial institution failures have often been associated with management-related problems such as serious internal control weaknesses, insider abuse and fraud, unresponsiveness to regulators, and disregard for the safety and soundness of financial operations.[1] Our findings were consistent with those of others, such as the Office of the Comptroller of the Currency, which recently cited poor management as a driving force behind bank failures.

We believe that any legislation designed to address federally insured financial institutions must underscore the importance of sound internal controls and specific compliance with laws and regulations and require public reporting of the same. In doing so, we believe that the regulatory and oversight process can be enhanced by drawing on the work of the independent auditor and by requiring that the independent auditor publicly report on management's internal control system and compliance with specific laws and regulations.

Our position on this matter is consistent with our letter to

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[1]Failed Financial Institutions: Reasons, Costs, Remedies and Unresolved Issues, Statement of Frederick D. Wolf, Director, Accounting and Financial Management Division, before the Committee on Banking, Finance and Urban Affairs, House of Representatives, January 13, 1989.

this committee in August of last year in which we discussed broadening the responsibilities of independent auditors in any legislation to provide new securities powers to banks. (See attachment.) In our letter we stated that an effective system of internal controls is essential to entities operating in today's complex and fast-moving financial markets. Since independent audits are an integral part of the regulatory and oversight process, reporting on internal controls and compliance with laws and regulations as part of these audits would greatly enhance their purpose and usefulness.

As we stated in our letter, management should be required to prepare the report on internal controls and compliance with laws and regulations, with the independent auditor required to review and report on management's assertions regarding internal controls and compliance. During this review, the independent auditor should determine whether the entity has internal controls to provide reasonable assurance that it complies with laws and regulations. The format of the reports by management and by the auditors could be designed by federal regulatory authorities, in consultation with GAO.

Requiring internal control and compliance reviews and reports is not a new concept. The Securities and Exchange Commission has proposed rules that would require public companies to assess and report on their internal control systems. Also,

the Congress passed the Single Audit Act of 1984 (Public Law 98-502), which requires CPAs auditing state and local governments to evaluate and report on internal controls and compliance.

In the past, the AICPA has worked cooperatively with us and others in bringing about these types of constructive reporting changes.

Mr. Chairman, auditing can--and should--play a key role in helping to ensure the safety and soundness of federally insured S&Ls. Our work, however, shows that significant improvements are needed to be able to fully rely on independent audits performed by CPAs. We believe those improvements can--and will--be made by the public accounting profession. Such improvements, combined with a broadening of the auditors' responsibilities for reviewing and reporting on internal controls and compliance with laws and regulations, can go a long way toward bringing about improvement in the regulation and oversight of the nation's S&L industry.

This concludes my statement, Mr. Chairman. We will be pleased to respond to any questions you or the other members of the committee may have.

GAO
United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

B-229444

August 5, 1988

The Honorable Fernand J. St Germain
Chairman, Committee on Banking,
Finance and Urban Affairs
House of Representatives

Dear Mr. Chairman:

We are writing this letter to discuss some items that we believe should be addressed in any legislation to provide new securities powers to banks. Specifically, while the proposed legislation (Depository Institutions Act of 1988) provides several "firewalls" and safeguards to ensure the safety and soundness of the nation's banks, we believe that two further items should be added to ensure that the safeguards are in place and are functioning properly.

Current bank regulations do not require independent financial audits of all banks. We strongly urge that, if a bank or bank holding company has a securities affiliate, it should be required to obtain an annual independent audit of both the bank and securities entities' financial statements, regardless of any regulation that may allow it to do otherwise. The entity should be required to submit these audit reports to the applicable bank regulatory agency. Such audits would provide an additional safeguard to ensure the securities affiliate's activities are not adversely affecting the banks and to ensure the safety and soundness of the nation's banking system. The Federal Deposit Insurance Corporation has been evaluating the audit issue as it relates to small banks. We recognize that an exemption from this requirement for small banks may be appropriate. However, the volume of securities transactions and other thresholds should be considered to ensure that a small bank with a significant level of securities activities is not exempt.

In addition, while the proposed legislation requires the three bank regulatory agencies and the Securities and Exchange Commission (SEC) to establish a compliance monitoring program, we believe that it would also be beneficial to specifically require management to report on the adequacy of the entities' internal controls and on compliance with the firewall and safeguard provisions of this proposed legislation (and any applicable regulations). Moreover, as part of the annual financial

audit, independent auditors should be required to review and report on management's assertions regarding internal controls and compliance. During this review, the independent auditor should determine whether the entity has internal controls to provide reasonable assurance that it complies with the act.

An effective system of internal controls is essential to banks and other entities operating in today's complex and fast-moving financial markets. In this regard, our ongoing analyses of the factors contributing to the failures of banks and savings and loan associations, as well as a June 1988 Office of the Controller of the Currency report on national bank failures, clearly show that inadequate internal controls are a primary factor in the vast majority of those failures. Since financial audits are an integral part of the system of safeguards for banks and the banking system, reviewing internal controls and compliance with the act as part of these audits would greatly enhance their purpose and usefulness.

Requiring internal control and compliance reviews and reports is not a new concept. The SEC has recently issued for comment proposed rules that would require public companies to assess and report on their internal control systems. Also, in 1984, the Congress passed the Single Audit Act of 1984 (Public Law 98-502), which requires most state and local government units to have independent audits. In addition to issuing an opinion on whether the financial statements present fairly the entity's financial position and results of operations in accordance with generally accepted accounting principles, as part of the audit, the auditor is also required to determine (and report on) whether:

-- the entity has internal accounting and other control systems to provide reasonable assurance that it is managing its federal assistance programs in compliance with applicable laws and regulations, and

-- the entity has complied with laws and regulations that may have a material effect on its financial statements and on each major assistance program.

Requirements similar to those contained in the Single Audit Act could be added to the proposed legislation to provide a means to determine whether the firewalls and safeguards are achieving their purpose.

We are also sending this letter today to the Chairmen, Committee on Banking, Housing, and Urban Affairs, United States Senate, and Committee on Energy and Commerce, House of Representatives. I hope these suggestions will be useful in developing legislation to restructure the nation's financial industry. If we can be of any assistance, please contact me or Mr. Robert W. Gramling, Associate Director, at 275-9461.

Sincerely yours,

Frederick D. Wolf
Director